

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Oropeza Analyst: John Pavalasky Bill Number: AB 2792  
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 20, 2004  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Military Reservist Credit

### SUMMARY

This bill would allow a tax carryover credit to qualified military reservists who experience a loss of income during the taxable year they served in active duty.

### PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to mitigate the loss of income experienced by a qualified reservist due to being called to active duty.

### EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and apply to taxable years beginning on or after January 1, 2004, and before January 1, 2006.

### POSITION

Pending.

### Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the implementation concerns and legal impact discussed in this analysis.

### ANALYSIS

#### FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Income Averaging – Farmers

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	<u>  X  </u> PENDING

Department Director

Date

Gerald H. Goldberg

4/15/04

Under federal (but not California) law, starting in 1997, an individual taxpayer in the farming business is allowed to elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or a portion of his or her "elected farm income." If the election is made, tax for the current year is equal to the sum of (1) tax computed on taxable income reduced by elected farm income, and (2) the increase in tax that would result if taxable income for the three prior tax years were increased by an amount equal to one-third of the elected farm income.

In making this federal provision permanent, the committee report provides the following statement under *Reasons for Change*:

"Income from a farming business can fluctuate significantly from year to year due to circumstances beyond the farmer's control. Allowing farmers an election to average their income over a period of years mitigates the adverse tax consequences that could result from fluctuating income levels. The Committee believes that the election by farmers to average their income should be made permanent."

### THIS BILL

For the 2004 and 2005 taxable years, this bill would allow a credit to qualified reservists (defined as members of the National Guard or the military reserves called to active duty on or after January 1, 2003) that experience a loss of income during the taxable year they served on active duty. The qualified reservist would also be required to be a California resident at the time the individual was called to active duty to qualify for this credit.

The credit would be equal to the difference between:

- the net tax (computed using the current year tax rate) on total income for the first year of a two consecutive year period (elected by the taxpayer) containing one year that the taxpayer served in active military service; and
- the net tax (computed using the current year tax rates) on 50% of the total income of that two consecutive year period.

This bill would allow any unused credit to be carried over until exhausted.

### IMPLEMENTATION CONSIDERATIONS

1. This bill uses terms that are undefined, i.e., "United States Military Reserve," "called to serve," and "active military service." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit. In addition, the bill does not require that the call to active military service to be for a period in excess of 30 days and, thus, the two-week annual active duty requirement and any active duty for training or attendance at a service school would qualify all "qualified reservists" (members of the National Guard or a reserve component of the armed forces) that are California residents for this credit.

2. One requirement of the credit is that the individual must have experienced a loss of income during the year in which the individual served in active military service. However, in calculating the "qualified net tax" the term "difference between" rather than "excess of" is used. It would be possible under the "difference between" language to generate a credit when the qualified reservist had greater income during the year they served in active military service. That is, they made more from active military service than they did in their civilian job or, in the case of a joint return, the spouse enters the workforce and that spouse's additional income makes the total income on the joint return greater than the preceding year's income. In addition, if a qualified reservist is serving in a combat zone (i.e., where all of his or her compensation for military service would be excluded from gross income), it is questionable whether the "loss of income" requirement would be satisfied by that reduction in taxable income, particularly when there might be an overall increase in economic income.

3. The bill does not provide any rules for the following situations:

- The qualified reservist is married and files a joint return with a spouse for the full two-year period.
- The qualified reservist is married to another qualified reservist but each is called to active duty in different taxable years.
- The qualified reservist gets married during the two-year period.
- The qualified reservist gets divorced during the two-year period.
- The qualified reservist gets divorced and remarries a different spouse during the two-year period.

Not having rules for these situations could lead to disputes with taxpayers and would complicate the administration of this credit.

4. This credit would require the addition of a worksheet to the tax forms booklets. By itself, enactment of this credit would not significantly impact the department. However, if this and two other credits requiring similar worksheets were enacted, the tax form booklets would need to be extended. The addition of extra pages to the tax forms booklets would require significant printing costs.

5. If this bill were enacted in late September or October of 2004, the department would have developed the forms and instructions for the 2004 taxable year. Thus, the department may incur additional costs to develop alternative forms and instructions in the short time frame necessary to ensure they are available for taxpayers to claim this credit.

6. This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

## **LEGISLATIVE HISTORY**

SB 1713 (Machado, 2003/2004) would conform California law to the changes by the federal Military Family Tax Relief Act Of 2003. This bill is currently in the Senate Appropriations Committee.

SB 1172 (Ackerman, 2003/2004) would provide expressly that California is conformed to federal statutes that limit or preempt California's ability to tax the California source income of specified nonresidents. This bill is currently on the Senate Consent Calendar.

AB 1073 (Dutton, et al., 2003/2004) would exclude from tax the death gratuity paid to the survivor of a deceased member of the Armed Forces of the United States. This bill is currently in the Senate Revenue and Taxation Committee.

AB 2952 (Mountjoy, et al., 2003/2004) would exempt all income of a spouse of a member of the Armed Forces who dies as a result of certain military-type actions from income taxes for the year of the member's death and the following three years. This bill is currently in Assembly Revenue and Taxation Committee.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* has no personal income tax. *Illinois, Massachusetts, Michigan, Minnesota, and New York* laws contain no comparable tax credit for qualified reservists.

## FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

## ECONOMIC IMPACT

### Revenue Estimate

The revenue impact of bill would be a loss of PIT revenue shown in the following table.

	2004-05	2005-06	2006-07
Personal Income Tax	-\$4 million	-\$4 million	minor

### Revenue Discussion

There are approximately 220,000 reservists called up to active duty of which 11% or 24,000 are from California. Recent surveys conducted by the Reserve Officers Association have estimated that about 50% of the companies that had employees that were called up for military duty offered differential pay between civilian jobs and reservist pay.

Using that survey it is estimated that about 12,000 of the California reservists would incur a significant reduction in income while serving on active duty. If, on average, each reservist incurred a reduction in income of \$12,000 for the year that they served, the tax credit would be based on \$6,000 average income reduction after averaging the two years.

Assuming an effective tax rate of 6%, the average tax credit would be \$360 (6% x \$6,000). Multiplying the \$360 average credit by the number of reservists that are incurring an income reduction (12,000) yields a PIT revenue loss of approximately \$4 million ( $\$360 \times 12,000 = \$4 \text{ million rounded}$ ) beginning in the 2004-05 fiscal year. The formula for the calculation of the \$4 million revenue loss is (220,000 US reservists x 11% California x 50% no differential pay x \$6,000 average income for the tax credit x 6% effective tax rate = \$4 million rounded).

## **LEGAL IMPACT**

This credit would be limited to qualified reservists who are residents of California at the time they are called to active duty. However, restrictions based on residence of a taxpayer have been found to be unconstitutional. The author may wish to restrict the credit to a "California taxpayer" rather than a "California resident."

## **LEGISLATIVE STAFF CONTACT**

John Pavalasky  
Franchise Tax Board  
845-4335  
[john.pavalasky@ftb.ca.gov](mailto:john.pavalasky@ftb.ca.gov)

Brian Putler  
Franchise Tax Board  
845-6333  
[brian.putler@ftb.ca.gov](mailto:brian.putler@ftb.ca.gov)